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Implications of the Oil Price Decline

**Special National Intelligence Estimate
Memorandum to Holders**

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*SNIE 3-85
April 1986*

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THIS ESTIMATE IS ISSUED BY THE DIRECTOR OF CENTRAL INTELLIGENCE.

THE NATIONAL FOREIGN INTELLIGENCE BOARD CONCURS, EXCEPT AS NOTED IN THE TEXT.

The following intelligence organizations participated in the preparation of the Estimate:

The Central Intelligence Agency, the Defense Intelligence Agency, the National Security Agency, and the intelligence organizations of the Departments of State, Treasury, and Energy.

Also Participating:

The Assistant Chief of Staff for Intelligence, Department of the Army

The Director of Naval Intelligence, Department of the Navy

The Assistant Chief of Staff, Intelligence, Department of the Air Force

The Director of Intelligence, Headquarters, Marine Corps

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Memorandum to Holders of SNIE 3-85

IMPLICATIONS OF THE OIL PRICE DECLINE

Information available as of 17 April 1986 was used in the preparation of this Estimate, which was approved by the National Foreign Intelligence Board on that date.

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SCOPE NOTE

The August 1985 Estimate *Implications of an Oil Price Decline* (SNIE 3-85) focused on the economic impact on consuming and producing countries and the international financial system over the midterm—through 1990—of a decline in oil prices to the \$20 per barrel level. We believe the judgments in that paper are substantially correct even under current market conditions. With the decline in prices to below \$17 per barrel, this Memorandum reviews some of those judgments as they apply to even lower prices over the same time period, looking more closely at the issues of (a) Saudi oil policy, (b) the implications for producing and consuming states, and (c) the impact on US strategic interests and Western energy security. [REDACTED]

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As with the original Estimate, this Memorandum focuses on the positive and negative effects of lower oil prices on US interests; the benefits clearly outweigh the potential costs by a wide margin. The balance of the paper, however, focuses on the possible negative implications for US interests, reflecting the role of the Intelligence Community in advising US policymakers. [REDACTED]

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KEY JUDGMENTS

Absent a decision by Saudi Arabia and other major producers to cut production, we believe downward pressure on oil prices will continue for several months. The market will be especially vulnerable over the next two to three months as seasonal factors further cut demand by as much as 2-3 million barrels per day. Indeed, the major producers may be unable to halt the price decline under these market conditions, and prices could fall to \$10 per barrel or less for short periods of time.

We believe a combination of objectives were behind Riyadh's decision to drop its role as swing producer:

- To increase near-term oil revenue.
- To force other producers to reduce output.
- To ensure a long-term market for Saudi oil.

In our judgment, these objectives would be met if prices stabilized about \$15 per barrel, a level that would accommodate short-term revenue needs and improve demand prospects for Saudi oil in the middle to long term. Despite the rate of the price decline, Riyadh does not yet appear ready to cut production. The Saudis probably would like to see prices fall to about \$10 per barrel, then hope they can raise prices to a somewhat higher level with renewed cooperation from other OPEC members.

Iran, Iraq, and Libya will be among the biggest losers should oil prices remain in the \$10 to \$15 per barrel range. In this circumstance:

- The prospects for social unrest in *Iran* will increase, and the regime over time will be forced to scale back military operations and may reevaluate its war policy. We do not believe, however, that Iran will abandon its ultimate objectives.
- Disgruntlement over economic conditions in *Iraq*, coupled with the military's unhappiness over the management of the war, will increase chances for Saddam Husayn's assassination or, less likely, his overthrow.
- The regime in *Libya* also will come under even greater domestic pressure as Qadhafi is forced further to cut back imports.

The moderate Arab oil-exporting states also will suffer substantially in the event prices remain in the \$10 to \$15 per barrel range, but we do

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not see those governments as being threatened in the near term from domestic discontent, although Saudi Arabia and Kuwait will face increased external threats from Iran. Tehran may step up pressures beyond attacks on tankers by sponsoring terrorist attacks against Gulf state oil facilities and officials. We do not believe, however, that Saudi Arabia will directly change its oil policy as a result of such attacks.

Among other oil producers, Egypt, Mexico, and Nigeria all will suffer from reduced oil earnings. An unprecedented series of political setbacks in Egypt already has seriously eroded President Mubarak's ability to deal effectively with the country's problems. Mexico faces the potential for serious social unrest if oil prices plunge to \$10 per barrel and stay there. Meanwhile, Nigerian President Babangida's regime will be hard pressed to survive if oil prices continue to fall.

The Soviet Union, which relies on oil and gas for 60 percent of its hard currency earnings, also is a major loser in the price decline. We estimate that, for the remainder of the decade, these earnings will be on the order of half the level they were in the early 1980s, given the range of anticipated prices.

The decline in oil prices entails both substantial benefits and risks for the Western countries; we believe the benefits outweigh the costs by a wide margin, however, even if prices stabilize below \$15 per barrel. This presumes that problems for the financial systems both here and abroad that result from lower oil prices are contained in a timely fashion. In terms of benefits, the oil price decline will raise the GNP growth rate by at least 1 percentage point at \$15 per barrel and as much as 1.5 percentage points should prices fall to \$10 per barrel. Consumer price increases in the Big Seven countries will remain below 5 percent. There are significant short-term oil- and gas-related problems for Canada, Norway, the United Kingdom, and the Netherlands; but we believe these countries eventually will benefit as nonoil exports are stimulated to other countries.

Even in those countries where the net financial benefits clearly favor oil consumers, however, lower oil prices are producing sectoral and regional problems. In the United States, five large Texas banks were just downgraded as credit risks, in part because of the impact of lower oil prices on their debtors. The solvency of large Canadian banks also is being threatened by the decline in world oil prices.

Lower oil prices could undo energy security gains achieved during the 1970s, hastening our return to greater dependence on imported oil supplies. In addition, sustained lower oil prices will reduce production and induce increased consumption. Our analysis shows that these trends could result in an increase in the demand for OPEC oil on the order of 7

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million b/d by 1990. This increase would erode a large share of surplus capacity, leaving the market open to supply disruptions and significant increases in real prices. Under these circumstances, the Saudis' enviable reserve position and increased market share would give them considerable economic and political leverage, which they might at some point use to advance political objectives.

In addition, we believe oil prices in the \$10 to \$15 per barrel range will improve chances for the Soviets to increase their share in West European gas markets if relatively expensive Norwegian supplies are not developed.

There is substantial uncertainty in these estimates of increased reliance on Middle East supplies and the erosion of surplus capacity:

- The supply and demand estimates represent a central forecast based on a series of assumptions such as economic growth, the rate of conservation, and the rate of decline in relatively high-cost production—each of which are subject to substantial error. Should conservation continue at a significant pace because of concerns over price rises in the 1990s, considerable surplus capacity could be available well past the end of the decade.
- Also, Iran and Iraq have the potential to increase significantly capacity and supply to the market; the rate of these potential additions depends on the course of the war and future investment decisions in Baghdad and Tehran. A victory by Iran, on the other hand, could result in destruction of some facilities and, hence, a reduction in capacity from current levels.

Moreover, Persian Gulf countries provide about one-fourth of total non-Communist oil supplies, and most of the oil still flows through the Strait of Hormuz. Although the risk is small, the loss of most Persian Gulf oil supplies for a prolonged period would cause oil prices to rise sharply and cause serious problems for the OECD economies.

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INTRODUCTION

1. Absent a sharp cutback in oil production by Saudi Arabia and other major producers, the market outlook offers little relief for producers in 1986. Although we may see some short-term production cuts in reaction to market forces, non-OPEC producing countries are unlikely to voluntarily cut output substantially below the current level of about 27 million b/d despite continuing pressures from OPEC countries. Non-OPEC producers consume a large portion of their output, with net exports amounting to only about 6.5 million b/d. Because the exports of non-OPEC producers amount to less than 15 percent of non-Communist oil demand, it would be difficult for them to balance the market without making unacceptably large reductions in output. On the demand side, even at current prices of about \$15 to \$17 per barrel, non-Communist oil consumption will rise by only about 1 million b/d this year to 46 million b/d. []

2. Consequently, the onus is on OPEC and Saudi Arabia in particular to stabilize prices above current levels. To do so, we believe they would have to limit production to less than 18 million b/d, including natural gas liquids. Financial considerations, however, limit both the ability and willingness of most producers to hold down output for any length of time. OPEC production presently is running about 19 million b/d, and most countries, rather than cutting back, are trying to raise market share as prices fall. Saudi Arabia, which is currently producing about 5 million b/d, will play a key role in the months ahead as other OPEC countries as a group appear determined to produce above 14 million b/d. (See inset on oil market forces and figure 1.) []

Saudi Strategy

3. We do not have [] direct knowledge of Saudi strategy and intentions. On the basis of government's statements and actions, we believe Riyadh's oil strategy has several goals—increase revenues, force other producers to lower their output, and ensure a long-term market for Saudi oil. Saudi priorities are subject to change in response to market changes as well as to political and economic considerations. []

Oil Market Forces

Over the past four months, oil prices have fallen further and faster than most energy market forecasters predicted. The average world oil price has declined to about \$15 to \$17 per barrel currently compared with \$27 per barrel last year. The collapse was the culmination of a number of factors:

- From 1979-85 non-Communist oil consumption fell by 7 million b/d in response to conservation and substitution of other fuels for oil.
- At the same time, non-OPEC production rose 6 million b/d.
- As a result, OPEC oil production dropped by about 15 million b/d or 50 percent from 1979 to 1985.

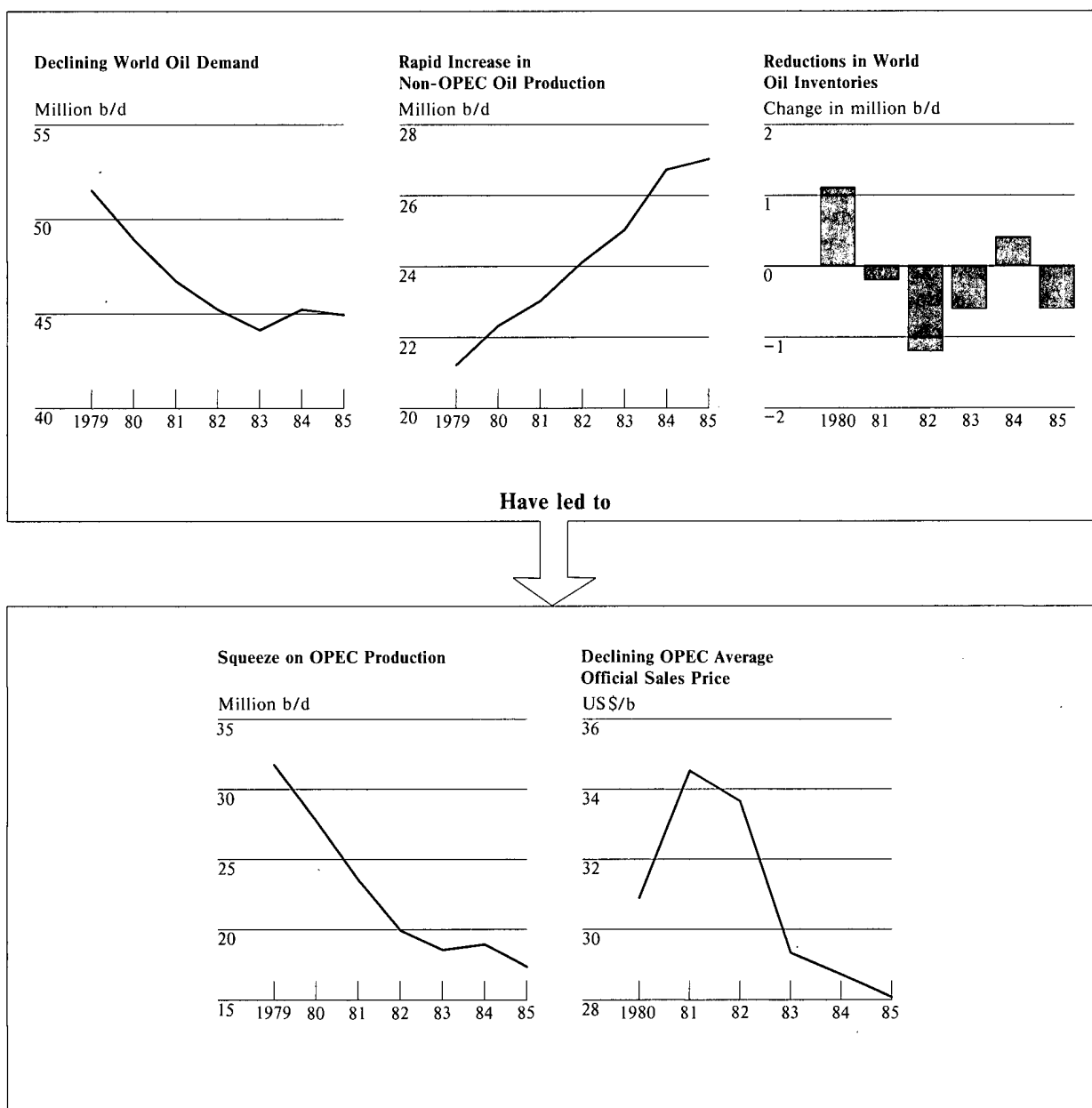
Faced with eroding market share and a total surplus capacity of about 10 million b/d, Saudi Arabia and other OPEC countries decided late last year to defend market share, rather than prices. The Saudi decision to abandon its role as swing supplier and move aggressively to recapture market share triggered the downward price spiral. []

4. The need to raise oil revenues last summer and the lack of production restraint by other producers prompted the Saudis to abandon their role as the swing producer in OPEC—the member who could maintain a world price by raising or lowering output. Revenues initially increased when the Saudis doubled their output; these gains now are being undercut by the plunge in prices but remain well above the nadir of last summer (figure 2). The Saudis appear resigned to draw on their liquid foreign reserves—which we estimate were \$70 billion at the end of 1985—at the rate of \$15-20 billion a year as the short-term cost of pursuing their other policy objectives. []

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Figure 1
Squeeze on OPEC Oil Producers



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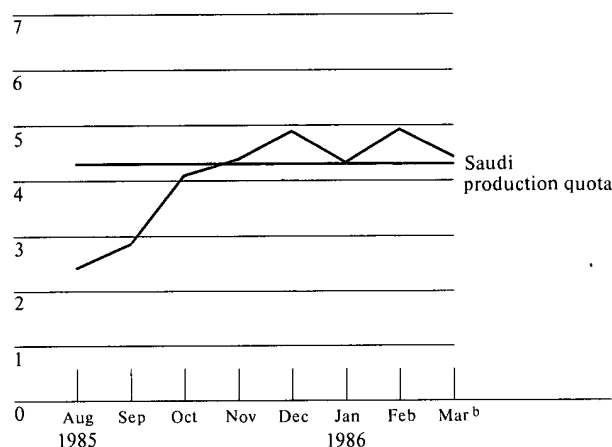
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Figure 2
Saudi Oil Production and Average World Oil Prices

Saudi Oil Production^a

Million b/d

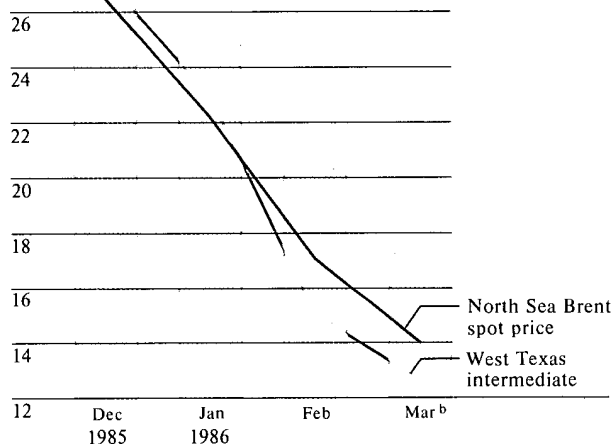


^a Includes Neutral Zone production.

^b Preliminary.

Average World Oil Prices

US \$/b



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6. At this juncture, the Saudis appear ready to see average prices fall to \$10 per barrel or less, then hope they can raise prices to a somewhat higher level with renewed cooperation from other OPEC members. In our judgment, a price level of \$15 per barrel would accommodate short-term revenue needs, improve demand prospects for Saudi oil in the middle to long term, and might even spur limited producer cooperation—especially if prices drop sharply over a brief period. Indeed, Saudi Arabia's strategy for capturing a greater market share has been successful so far. Demand for oil is beginning to show signs of life in response to lower prices and could register its largest annual increase since the late 1970s. Some high-cost production is also beginning to be shut in because of lower prices, a positive development in Riyadh's view.

[Redacted]

7. The sharp drop in prices as a result of the current Saudi strategy is causing acute revenue problems for other producers. Hence, this strategy carries a substantial risk of reprisal from radical oil producers, particularly Iran, and has caused unease among Saudi Arabia's conservative Arab allies. [Redacted]

Price Outlook—Possible Variables

8. Even if the Saudis decide to try to maintain average prices at about \$15 per barrel—about 50 percent below last year's level—we cannot rule out a

collapse of average prices to \$10 per barrel or even less. Uncertainties over OPEC actions, seasonal factors, inventory behavior, and the changing nature of oil marketing and pricing will all contribute to price fluctuations under this scenario. [Redacted]

9. The size and complexity of the oil market and the move toward market-related pricing may make it difficult for Saudi Arabia and other producers to control a rapid price decline. The market will be especially vulnerable to a price war over the next several months as seasonal factors temporarily cut oil demand by as much as 2-3 million b/d. Seasonal demand will pick up again in the fall. We believe market forces will prevent prices from remaining substantially below the \$10 level. These forces include the likelihood of a large speculative stockbuild and the shutting in of high-cost production. [Redacted]

Widespread Economic Benefits

10. Because oil costs consumers roughly \$400 billion per year at 1985 prices, the decline in oil prices will produce substantial benefits for oil users—benefits that, for the developed countries, far outweigh the costs of a price decline:

- Consumers are experiencing reductions in retail petroleum product prices that are leaving them with increased spending power.

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- For nonoil businesses, the fall in energy-related production costs is increasing sales, profit margins, and growth prospects.

The magnitudes of these shifts in income are enormous. Assuming a full pass through to consumers of the decline in oil prices from \$27 to the present \$17 per barrel, some \$150 billion annually would be transferred from oil producers to users, a magnitude exceeding 1.0 percent of global GNP in its direct, initial benefit. A decline to \$10 a barrel would shift an additional 0.75 percent of global purchasing power.

11. For the OECD, our analysis, on the basis of the CIA econometric model of the world economy suggests growth will increase 1 percentage point at \$15 per barrel oil and about 1.5 percentage points at \$10 per barrel compared with conditions at \$27 per barrel (table 1). Inflation also will be reduced substantially; if oil prices fall to \$10 per barrel, annual consumer price increases of under 5 percent in each of the Big Seven countries are likely. This analysis presumes that the problems for the financial systems both here and abroad that result from sharply lower oil prices are contained in a timely fashion.¹

Some Problems for Developed Country Producers

12. Even in those countries where the net financial benefits clearly favor oil consumers, lower oil prices are producing sectoral and regional problems. In the United States, for example, five large Texas banks were just downgraded as credit risks, in part because of the impact of lower oil prices on their debtors. Unemployment in Texas, Oklahoma, and Louisiana—major energy producing states—ranges from 1 to 5 percentage points above the national average.

13. The solvency of large Canadian banks also is being threatened by the decline in world oil prices. For example, the Canadian Imperial Bank of Commerce (CIBC), the country's third-largest bank with assets of \$56 billion, may face insolvency shortly because of a decision of Dome Petroleum to declare a 14-month moratorium on payments of both principal and interest on its more than \$1 billion loan from the CIBC. Two other major Canadian banks—the Bank of Montreal and Toronto Dominion—are also having solvency problems because of loans outstanding to Dome. All three banks increased the funds they have earmarked for loan losses in the energy sector during March.

¹ Treasury believes these problems will be country specific internationally and limited geographically in the United States rather than of a more general nature.

Near-Term Energy Security

Substantial surplus production capacity currently provides the oil market considerable protection against all but major supply disruptions. Surplus available production capacity averages about 10 million b/d, but only 3 million b/d of this lies outside the Gulf region. Persian Gulf countries still provide about one-fourth of total non-Communist oil supplies, and most of the oil still flows through the Strait of Hormuz. An escalation in the Iran-Iraq war would raise the probability of a Persian Gulf oil disruption. Furthermore, Iranian and Libyan threats against Saudi Arabia for its oil-marketing strategy raise the possibility of a disruption of Saudi oil exports. Although the risk is small, the loss of most Persian Gulf oil supplies for a prolonged period would cause oil prices to rise sharply and cause serious problems for the OECD economies.

The impact of a disruption would depend on its severity and duration:

- The market could absorb most actions relatively easily, including a loss of all supplies from Iraq, Iran, and Kuwait.
- Spot prices would rise temporarily, however, if buyers anticipated further spreading of the conflict.
- A severe problem would arise, however, if Saudi oil exports were also cut or if all oil shipping in the Persian Gulf were halted.
- A drawdown of strategic oil stocks will mitigate, at least partially, the effect of a disruption

14. Among the developed countries, the greatest burden of lower oil prices falls on countries depending heavily on oil for export earnings, government revenue, and economic activity in general. On this count, Norway, the United Kingdom, the Netherlands, and Canada will be hurt in the short run because of the importance of oil and natural gas to their domestic economies. We believe these countries will eventually benefit from lower oil prices, however, as nonoil exports to other countries are stimulated.

Implications for LDC Oil Exporters

15. Oil prices in the range of \$10 to \$15 per barrel will cause serious problems for many oil-producing countries. In some cases, we believe the problems will be sufficiently severe to threaten the government, particularly if prices fall to \$10 per barrel and remain at that level for a year or two. In all cases, the problems caused by oil prices represent an intensification of existing difficulties; the magnitude of the oil

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Table 1
Lower Oil Prices: Estimated Effects ^{a b}

Industrial Country Oil Importers						
	Change in Real GNP Growth ^c (percentage points)		Change in Inflation ^c (percentage points)		Change in Net Oil Import Costs ^d (billion US \$)	
	\$15	\$10	\$15	\$10	\$15	\$10
United States	1.8	2.7	-1.9	-2.8	-17.0	-24.4
Japan	0.4	0.6	-0.5	-0.7	-17.0	-24.4
West Germany	0.6	0.9	-0.7	-1.1	-9.0	-12.9
France	0.4	0.6	-0.9	-1.3	-6.5	-9.4
Italy	0.7	1.1	-1.0	-1.5	-6.3	-9.1
Smaller OECD	0.2	0.3	-0.8	-1.2	-12.4	-17.9
Industrial Country Oil Exporters						
	Change in Annual Net Oil Exports as a Share of Total Exports ^d (percent)		Change in Annual Government Revenues as a Share of Total Revenues ^d (percent)			
	\$15	\$10	\$15	\$10		
United Kingdom	-6	-8	-4	-5		
Norway	-11	-15	-10	-13		
Canada	-2	-4	-2	-3		
LDC Oil Importers						
	Change in Annual Net Foreign Exchange Receipts ^e (billion US \$)		Change in Annual Net Foreign Exchange Receipts as a Share of Imports, Debt Service, and Reserves (percent)			
	\$15	\$10	\$15	\$10		
Brazil	3.0	4.3	7	10		
Philippines	1.0	1.5	10	14		
South Korea	3.0	4.3	7	10		
Thailand	1.1	1.6	7	10		
LDC Oil Exporters						
	Change in Annual Net Foreign Exchange Receipts ^e (billion US \$)		Change in Annual Net Foreign Exchange Receipts as a Share of Imports, Debt Service, and Reserves (percent)			
	\$15	\$10	\$15	\$10		
Egypt	-1.1	-1.5	-7	-7		
Indonesia	-6.1	-8.7	-29	-41		
Malaysia	-0.7	-1.0	-3	-5		
Mexico	-5.3	-7.3	-18	-27		
Nigeria	-6.1	-8.7	-38	-54		
Venezuela	-5.4	-7.8	-22	-32		

^a Estimates of impacts for both \$15 and \$10 prices are against a baseline world price of \$26.50.

^b Treasury, using a different methodology, projects significantly different magnitudes in some cases, including smaller average effects on inflation and GNP growth in the United States, but arrives at similar conclusions.

^c Estimates are from the CIA Linked Policy Impact Model of the world economy, assuming a cut in OPEC import spending equal to two-thirds of the revenue decline. These figures represent the yearly average for the first three years after the price decline.

^d Assumes each country's volume of net oil trade is unchanged.

^e Incorporates estimated effects of lower oil prices on interest rates and global economic growth.

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Table 2
Non-Communist Oil Production
and Capacity, 1985

	Average 1985 Production ^a (million b/d)	Capacity (million b/d)
OPEC total	17.5	27.4
Algeria	1.0	1.2
Ecuador	0.3	0.3
Gabon	0.2	0.2
Indonesia	1.3	1.6
Iran	2.3	3.2
Iraq	1.5	1.8
Kuwait ^b	1.2	1.6
Libya	1.2	1.8
Nigeria	1.5	2.2
Qatar	0.3	0.6
Saudi Arabia ^b	3.8	8.8
United Arab Emirates	1.2	1.7
Venezuela	1.7	2.4
Non-OPEC totals	27.0 ^c	27.3
United Kingdom	2.7	2.7
Norway	0.8	0.8
Mexico	2.9	3.2
Egypt	0.9	0.9
Canada	1.8	1.8
United States	10.6	10.6
CPE exports	1.6	1.6
Others	5.7	5.7
Non-Communist totals	44.5	54.7

^a Includes natural gas liquids.

^b Includes Neutral Zone.

^c Excludes refinery gain.

decline simply brings these problems forward. (See inset on near-term energy security, table 2, and figure 3.)

Iran, Iraq, and Libya

16. Iran, Iraq, and Libya will be among the hardest hit by sustained low oil prices. Over time, lower oil revenues would increase the prospects for unrest in *Iran*, including antiregime demonstrations, strikes, and sabotage. If oil prices fall substantially below \$15 per barrel, Iran over the longer term probably would be forced to scale back military operations and indeed may reevaluate its war policy. Iran would not, however, declare a formal peace or abandon its ultimate objectives. A major military setback, coupled with

decreased oil revenues, would threaten the survival of the regime more quickly and result in more repressive domestic actions.

17. The fall in oil prices deals a serious blow to *Iraq's* policy of paying for the war and shielding the population from deprivation. Unless Baghdad's Persian Gulf allies increased their already sizable aid, economic difficulties would lead to civil unrest. Moreover, if Iraq suffers a series of major reversals on the battlefield, disgruntlement in the military will grow, increasing the chances of Saddam Husayn's assassination or, less likely, his overthrow. Under these circumstances, Saddam's ouster could be perceived as an Iranian victory by other Gulf states and their populations.

18. Falling oil prices will also cause severe problems for *Libya's* economy and may even threaten the regime. A price of \$10 per barrel, for example, would exhaust available foreign exchange reserves of \$5.1 billion—not including \$1.3 billion in gold and \$800 million in frozen US bank accounts—within a year unless massive cuts are made in already substantially reduced import levels. In the past, Qadhafi has been reluctant to let foreign exchange reserves fall below \$2.5 billion. Import reductions of up to \$3 billion—including cuts in Soviet and other military imports—are the most that are likely. Deep reductions in imports would cause domestic disgruntlement—already growing because of Qadhafi's economic mismanagement and foreign adventurism—to reach regime-threatening levels and force Qadhafi to rely even more heavily on repression and security forces to remain in power.

19. Although depressed oil prices probably would persuade Qadhafi to be even more selective in funding foreign radical groups, the cost of such activities is so small—at most \$75 million annually—that he will continue to be a leading supporter of international terrorism and subversion. Although Qadhafi has threatened Saudi and other Gulf oil facilities and officials if Riyadh fails to reduce its oil production and help raise prices, we doubt Qadhafi will take direct military action. He may undertake terrorist attacks against Gulf officials and encourage Iran to disrupt Gulf oil supplies.

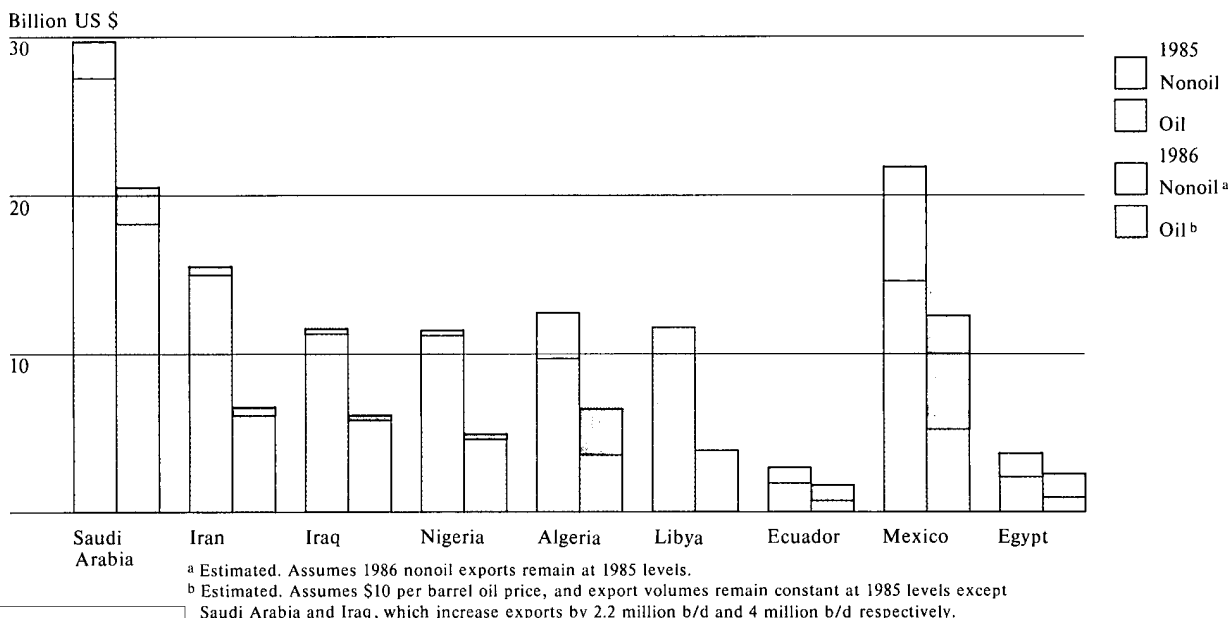
Moderate Arab Producers

20. Oil revenues of \$15-20 billion a year—the most *Saudi Arabia* could expect at \$10 per barrel oil—will force Riyadh to trim social welfare programs, further scale back military purchases, and continue to draw from their approximately \$70 billion in liquid foreign reserves. Despite budgetary pressures, however, the

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Figure 3
Oil Producers' Export Earnings With \$10 Per Barrel Oil



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reserves. Despite budgetary pressures, however, the Saudi royal family will not significantly curtail spending, already an item of criticism by Saudi commoners. If the Saudi reserve drawdown approaches \$20 billion a year, Riyadh may seek loans from international or domestic sources. The Saudis would only reluctantly make cuts in their foreign aid program. Aid to states peripheral to primary Saudi security interest most likely will be cut, but they would continue current levels of cash disbursements to Syria, Iraq, Jordan, and the PLO as the recipients most critical to their security interests.

21. We do not believe reduced oil revenues threaten the regime with unmanageable instability during the next year. In fact, most Saudis welcome the adoption of a "Saudi First" policy on oil production, a feeling that, for now, mitigates against serious political unrest. Nonetheless, the Saudis will have to make further significant cuts in subsidies, which, in time, will result in increasing frictions within the government. Perhaps more important, some businessmen and bankers, fearing a further erosion in the Saudi economy, very likely will liquidate domestic assets and cut back on lending and investments.

22. The small, oil-rich states of the Persian Gulf—Kuwait, Qatar, and the United Arab Emirates—have

not yet cut spending programs significantly. Although all three can still draw on their substantial foreign reserves to finance shortfalls and to minimize political fallout, a price drop to \$10 per barrel would force deep cuts in domestic spending, cancellation of additional development projects, and further reduction in foreign workers. These Gulf states also would cut back on foreign aid commitments; none is current on its Baghdad pact payments to the PLO, Syria, or Jordan. Austerity measures in *Bahrain* and *Oman*—neither has much of a financial cushion to draw on—would aggravate domestic tensions. In Bahrain, this could lead to unrest among the Shias, who are 60 percent of the population, and would bear the brunt of a downturn in employment and spending on domestic programs.

23. Saudi Arabia and the other moderate states also will face an increased threat from the more radical producers, particularly Iran and Libya. We believe Iran will make good on its threat to use force against the Gulf states in an attempt to force a change in Saudi policy and reverse the price slide. Tehran may step up pressures beyond attacks on tankers by sponsoring terrorist attacks against Gulf state oil facilities and officials. Direct military strikes against these facilities are far less likely, but they cannot be ruled out. We do

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not believe, however, that Saudi Arabia will directly change its oil policy as a result of such attacks []

24. The decline in oil prices poses severe economic and political difficulties for *Egypt* and could even threaten the Mubarak regime's hold on power. An unprecedented rash of political setbacks has already seriously eroded the government's ability to deal effectively with its rapidly deteriorating economy. Oil prices in the range of \$10 to \$15 per barrel oil for a sustained period of time probably would be economically and politically unmanageable without a substantial increase in external assistance. In addition to the direct effects of a decline in oil earnings, worker remittances and Suez Canal tolls are also falling. To gain international financial backing, Cairo would be forced to adhere to much stricter financial and monetary guidelines, including more rigorous subsidy reform—a move that almost certainly will raise consumer prices and increase the risk of violent political unrest. Faced with these circumstances, the Mubarak regime will push even harder for additional US financing and, in particular, will seek major relief from FMS debt repayment. []

Other Producers

25. President Babangida's regime will be hard pressed to survive as the fall in oil prices exacerbates *Nigeria's* already serious economic problems. The inability to improve living conditions, the failure to implement economic reforms including exchange rate adjustments, the emergence of recent political controversies over the execution of 10 military coup plotters, and the decision to join the Islamic Conference Organization leave Babangida poorly positioned to endure another plunge in oil prices. The 50-percent decline in *Nigeria's* oil export earnings between 1980 and 1985 in the absence of effective adjustment programs already has pushed the country to the brink of financial default. Lagos may stop or slow most of its debt payments in the near future to avoid more devastating cuts in imports. []

26. At \$15 per barrel, *Mexico's* oil revenues will decline by \$6.8 billion compared with last year; associated interest rate drops and greater nonoil exports offset only \$1.5 billion of the loss. At \$10 per barrel, *Mexico's* net loss due to lower oil prices approaches \$7 billion, one-third its export earnings in 1985. Government revenues—45-percent dependent on oil—are equally adversely affected.² []

² *Treasury believes the Mexican situation is manageable in 1986, with oil at \$15 per barrel, provided the government undertakes serious structural reform, interest rates continue to decline, oil prices stabilize, and some commercial bank and official debt due in 1986 is restructured.* []

27. We believe there is a significant chance for serious social unrest in *Mexico* for President de la Madrid to cope with if oil prices plunge to \$10 per barrel and stay there. The Mexicans, who have endured four consecutive years of declining real wages, will increasingly resist official appeals for yet greater sacrifices. We believe that de la Madrid would be able to muddle through to the end of his term in 1988. Nonetheless, he would pass on to his successor a seriously troubled political situation. []

28. Continued low oil prices will result in substantial budget cuts and probably will plunge *Ecuador's* economy into recession, exacerbating President Febres-Cordero's problems with the leftist opposition in congress and encouraging a small but active terrorist movement. Stiff economic adjustment measures seem unavoidable if *Ecuador* is to meet external interest obligations of about \$700 million. The President would be unable to implement the social program promised during the presidential campaign of 1984, giving the opposition useful ammunition. The result would be an even larger victory by opposition candidates in the June election and the end of Febres-Cordero's narrow control over Congress. []

The Natural Gas Market in Europe

29. Because gas prices are linked to the price of oil, they will fall to reflect the lower cost of competing fuels, and natural gas demand may grow even faster than projected. A sustained drop in oil prices to \$10 to \$15 per barrel could postpone development of North Sea natural gas and open the door for greater Soviet penetration into the West European gas market in the 1990s. []

30. Declining oil prices hold the potential for undermining the West European commitment to limit dependence on Soviet natural gas. In 1985, West European consumption reached a record 235 billion cubic meters (bcm), with the Soviets supplying about 15 percent of West European demand. Even before the price collapse, the International Energy Agency forecast that a gap of as much as 8-97 bcm per year was likely to emerge by the year 2000 between demand and supplies currently under contract. Prospects for the development of indigenous gas resources—primarily in the North Sea—were good, however, and would probably have limited further Soviet inroads. []

31. Lower prices raise the risk that Moscow will now capture an increasing share of the West European gas market. On the supply side, lower energy prices are likely, at a minimum, to delay the development of

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high-cost indigenous gas resources, like Norway's Troll field. Favorable tax policy will be required to ensure development. Failure to adequately improve the investment climate could make at least some natural gas development projects uneconomic. Oslo, however, has shown a willingness to adjust tax policy to maintain development and employment in the past and is reportedly prepared to make some concessions. []

32. The Soviet Union is well placed to capture any shortfall in indigenous supplies or growth in demand in the West European market because it has abundant gas reserves, a flexible marketing strategy, and the ability to increase deliveries with relatively short leadtimes. Indeed, the collapse of energy prices will increase Moscow's need to expand gas sales. (See inset on low energy prices and the Soviet Union.) []

Increased Long-Term Dependence on the Persian Gulf

33. In the oil market, lower prices could undo energy security gains achieved during the 1970s, hastening our return to greater dependence on imported oil supplies. Lower prices will raise oil demand, slow supply development, and cause an erosion of the cushion in surplus capacity, which is, at present, about 10 million b/d, and hasten a return to a tighter market. Although it is not possible to predict the magnitude or the timing of demand or supply responses, lower prices will certainly increase our use of Middle East oil supplies and cause an erosion in surplus capacity over the next several years. []

34. Although low oil prices will increase oil *demand*, the extent and pace of the growth are difficult to predict. The momentum toward greater technological efficiency and a less energy intensive service economy is strong. Conservation gains made over the last decade are unlikely to be reversed, although the pace of investment to substitute away from oil will slow if prices remain low. Investments in most energy-using equipment are based on long-term price expectations. There will be, however, some substitution of residual fuel oil for gas and coal in facilities that have dual capacity. Consequently, as long as the consensus outlook is for the potential for prices to rise by the early 1990s, there may be limited incentive for a major move back to oil-using capital equipment. []

35. Nevertheless, a sustained drop in oil prices to the \$10 to \$15 per barrel range will increase oil demand and cause a slowdown in conservation gains over the long term. Greater economic growth will increase oil demand. Higher incomes and lower oil prices will likely cause consumers to drive more and

Low Energy Prices and the Soviet Union: Difficult Choices Ahead

For years the Soviet Union has emphasized energy exports to the West as a means of earning hard currency. In 1985, almost 45 percent of Moscow's hard currency export earnings were from oil exports, with gas sales accounting for another 15 percent. The USSR will be unable to offset lower oil prices by increasing output. Even under the optimistic assumption that prices stabilize close to \$20 per barrel, Moscow's hard currency earnings from oil and gas sales will fall to about \$10-12 billion in 1986, compared with \$18-20 billion in 1984. If oil prices fall to \$10, with a proportionate change in the gas price, oil and gas earnings would plummet to almost \$7 billion—less than half the 1985 level. Faced with large drops in oil earnings, the need for increased revenues from additional gas sales becomes even more critical. Over the short term, however, the gas market will not expand fast enough to provide income sufficient to mitigate declining earnings resulting from lower energy prices. []

Moscow has several options available to cope with falling revenues, but none would be comforting to Soviet planners. Moscow could:

- Increase borrowing from the West, as it enjoys a favorable credit rating among Western lenders. The debt service ratio—which has long been 15 to 17 percent—has increased because of stepped up borrowing last year and the drop in earnings, however, and is expected to approach 25 percent this year. The USSR's financial conservatism is likely to prevent any major increases in borrowing.
- Increase gold sales to raise extra hard currency. Gold reserves are now valued at over \$25 billion, but we believe Moscow could increase gold sales only to a maximum of 450 tons in 1986 (\$4.5 billion) without a major market disruption.
- Draw down assets in foreign banks that total about \$10 billion. Moscow would be reluctant to significantly reduce these reserves, however, because this would leave an insufficient safety net in the event of, for example, a major harvest disaster.

Faced with these prospects, Moscow will have little choice but to lower imports. Indeed, Soviet planners this year are already reevaluating import plans and possibly their investment strategy because of hard currency shortages. Should energy prices remain low for the remainder of the decade, the USSR may have to reduce imports by one-third from the 1984 level of \$27 billion, leaving the Soviets with the difficult task of allocating the available hard currency among competing claimants. []

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encourage the purchase of less fuel efficient automobiles. We believe LDC oil-importing countries could also register higher growth in oil demand growth rates if prices are maintained at \$10 to \$15 per barrel for several years. In the aggregate, we believe, on the basis of the CIA energy model and industry estimates, that non-Communist oil consumption will rise by perhaps 5 million b/d, to roughly 50 million b/d by 1990. This includes 1-2 million b/d of additional demand expected even before the price plunge and 3-4 million b/d of demand generated by higher economic growth and substitution of oil for other fuels in reaction to lower prices. []

36. Lower prices will reduce non-OPEC oil supply. [] the short-term response will be only minimal until prices drop below \$15 per barrel, with most of the decline in the United States. At \$10 to \$15 per barrel, however, analysts predict 0.5-1.0 million b/d will be shut in during the first year—with at least half of this amount in the United States. Most operators can still cover their costs of production at these prices and will continue to operate. Even when prices fall below marginal cost, some producers will be reluctant to cut production for several reasons: the irreversibility of some closures, the high costs of reopening wells, contractual commitments, or expectations that prices will rebound in the near future. []

37. Over the longer term, the impact of oil prices on exploration and development activity will cause a decline in available supply. The number of active drilling rigs worldwide in 1985—one of the best indicators of current exploration and development activity and hence of future supply availability—was nearly 40 percent below peak 1981 levels. Most of the decline in activity took place in the United States (figure 4).

- Many companies have already slashed planned 1986 exploration and production expenditures by as much as 40 percent from budgeted levels. Although it is the future price of oil rather than the current price that is most relevant to the economics of new development, many oil firms lack the financial flexibility to embark on large numbers of costly programs in the current environment. The small independents—which drill nearly 90 percent of all US wells—have been particularly hard hit by the price drop.
- Some companies may be forced to drill only “have to” wells—those where the companies are committed by terms of licensing and concession agreements.

- Many firms will channel funds into the most promising existing discoveries at the expense of more speculative exploration activity. A higher percentage of funds may be channeled outside the United States because of better prospects for finding large reserves.

As a result, the proved oil resource base will decline. []

38. The full impact of declining exploration and development activity will not be felt for several years because of the long leadtimes involved in bringing new production on stream. Although improvements in drilling efficiency and declining costs will temper the impact of lower spending, the cumulative effect over time is likely to be lower production in the United States and other non-OPEC areas. In our judgment, if prices are maintained at \$10 to \$15 per barrel for several years, net non-OPEC supplies, mostly in the United States, could decline by 2 million b/d or more by 1990, compared with 1985 production levels. []

39. The net result of lower non-OPEC supply, coupled with higher demand, would be a 7-million-b/d increase in *demand for OPEC oil* by 1990, raising the organization's total output to about 24 million b/d, assuming oil prices are in the range of \$15 per barrel. At this level, many OPEC members would be producing close to capacity, increasing the possibility of price pressures should a major supply disruption take place. Higher demand and lower production could raise US net oil imports to about 7 million b/d by 1990—about 50 percent above 1985 levels—and make the United States dependent on imports to cover 40 percent of our total consumption, the highest level since 1979. The rate of increase in dependence on OPEC and the possibility for increase in the real price depend heavily on the path of prices over the next two to three years. If prices fall to \$10 per barrel, pressures for real increases in prices will develop before the end of the decade. At \$20 per barrel, the world could have a comfortable cushion of surplus capacity at least through 1990. []

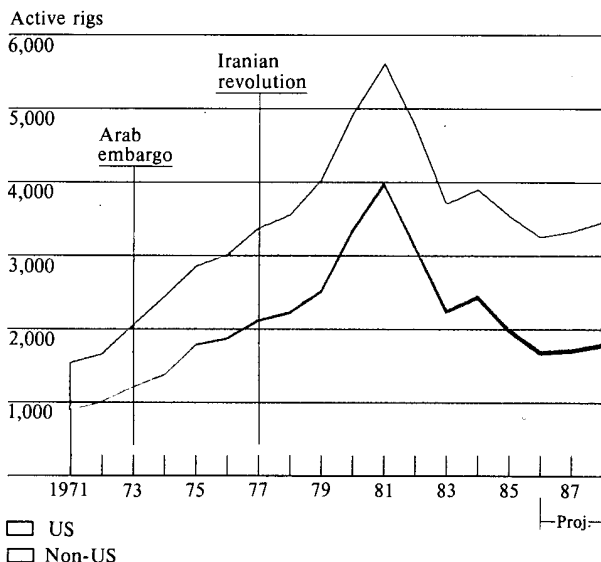
Market Uncertainties

40. As past experience with mid- to long-term energy forecasts shows, there are several uncertainties in these estimates. On the demand side, forecasters have had limited success predicting oil conservation and consumption trends in response to rising prices. Institutional barriers, expectations of higher prices in the 1990s, and continued greater-than-expected efficiency gains could slow oil demand growth. Although extremely unlikely, a prolonged recession during the

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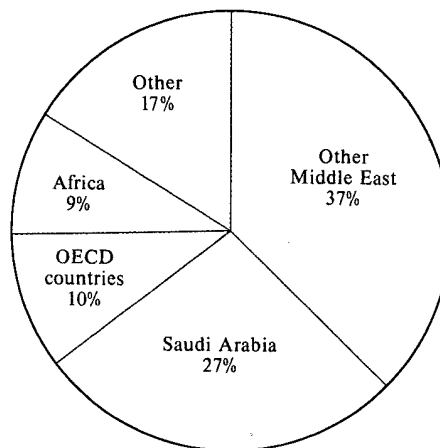
Figure 4
Non-Communist Active Drilling Rigs



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Figure 5
Non-Communist Oil Reserves

Yearend 1985



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next several years could also hold down oil demand and delay a return to a tight market situation.

41. Also, Iran and Iraq have the potential to increase significantly capacity and supply to the market. By the end of the decade, assuming Baghdad is able to follow through on its current plans, Iraqi export capacity will rise to 3 million b/d—an increase of about 1.5 million b/d—with the completion of the Second Phase of the Iraq-Saudi pipeline project and the expansion of the pipeline through Turkey. For its part, Tehran could decide to raise capacity by another 1-2 million b/d by the end of the decade should it be willing to spend the money and pay Western oil workers to repair the fields. The rate of these potential additions, however, depends on the course of the war and future investment decisions in Baghdad and Tehran. A victory by Iran, on the other hand, could result in a destruction of some facilities and hence, a reduction in capacity from current levels.

42. In any case, over the longer term, dependence on Middle East oil supplies will rise because of the concentration of current surplus capacity and low cost oil reserves in the region. Total non-Communist proved oil reserves were estimated at 619 billion barrels at yearend 1985. Nearly two-thirds of these reserves are located in the Middle East region (figure 5). Oil reserves in Saudi Arabia approximate 170

billion barrels, or about one-fourth of total world reserves and at 1985 production levels would have a life of about 120 years. In contrast, total proved reserves in all OECD countries combined are only 62 billion barrels, 10 years of production.

43. The Saudis' enviable reserve position and increased market share would give them considerable economic and political leverage, which they might at some point use to advance political objectives. A change in regime or another outbreak of Arab-Israeli hostilities might increase Riyadh's willingness to use oil as a political weapon. An effort to gain policy objectives through such means as an oil embargo could have severe economic repercussions.

Opportunities for the West

44. A period of sustained low oil prices does provide a number of policy options for the Western countries:

- Low oil prices reduce the economic cost of building strategic oil stockpiles and raising compulsory stock requirements. If the major consuming countries increased strategic oil inventories to a level comparable with that which already exists in the United States—the Strategic Petroleum Reserve currently holds the equivalent of 120 days of net US imports—most of the adverse

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days of net US imports—most of the adverse impacts of any future supply disruption could potentially be offset.

- Implementation of higher excise taxes on oil products would raise revenue and depress consumption. Indeed, several countries, including Italy, the United Kingdom, Spain, Portugal, Greece, and Ireland, have raised taxes on oil products in recent months.
- Some countries could also improve the investment climate for domestic development of ener-

gy resources, like the development of the Troll gasfield in the North Sea, by opening attractive new areas for exploration, lowering local ownership requirements, or offering more attractive fiscal regimes. Canada, for example, successfully encouraged record exploration and drilling activity last year by revamping its restrictive energy policy. Estimates for 1985 show that the industry responded enthusiastically to policy changes—well completions rose by 23 percent last year; capital and exploration expenditures, by 21 percent.

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